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October 28, 1996

David S. Guzy, Chief
Rules and Procedures Staff
Minerals Management Service
Royalty Management Program
P. O. Box 25165, MS 3101
Denver, CO 80225

Dear Mr. Guzy:

The following comments are submitted by the State and Tribal Royalty Audit Committee (STRAC) on the proposed rule of the Minerals Management Service (MMS) regarding the determination of transportation allowances in the post-FERC 636 environment (61 Fed. Reg. 39931). STRAC is an organization composed of the audit offices of eleven States and eight Tribes that work cooperatively with the Department of Interior in the audit of royalties owed from production on federal and Indian lands.

Before commenting on the specific MMS proposals, STRAC believes it important to make some general observations and recommendations.

First, transportation allowances, if not monitored closely, can reduce federal and Indian royalty revenues in unwarranted ways. Nowhere is this more true than in the case of acceptance of FERC tariffs, in lieu of actual costs, for determining allowances. STRAC strongly believes that careful examination of tariffs is needed to assure revenue protection and accountability.

STRAC has brought this issue to the attention of MMS before but was told that examination of tariffs should be viewed as an audit-related issue; i.e., it was not appropriate to address cost components of tariffs in the context of the current rulemaking. However, STRAC is also aware that at least some lessees, who currently use tariffs for determining their transportation allowances, believe that such tariffs are beyond MMS scrutiny once MMS has permitted their use. STRAC is also aware of situations in which lessees have refused to provide information concerning their actual costs of transportation when a tariff is being used to calculate a transportation allowance. Thus, STRAC urges MMS to make clear in this rulemaking that review of the costs included in a tariff are not beyond audit review by MMS and that transportation allowances may be re-calculated where it is found that the tariff does not reasonably reflect a lessee's actual costs.

Second, while STRAC recognizes that clarification of allowable tariff charges for transportation allowance purposes in the post-FERC 636 is an important and indeed pressing issue, STRAC urges MMS not to consider this rulemaking an end to issue of transportation allowances. As MMS notes with regard to Indian leases, the proposed use of index prices for valuation of gas will impact the viability and applicability of determining appropriate deductions for transportation. This is also true for federal leases.

For example, MMS justifies, in part, permitting the deduction of firm demand charges on the grounds that contracting for a fixed capacity entitlement will enable the sales of gas at higher prices. While STRAC does not believe that this will invariably be the case, increased use of index pricing will preclude MMS from capturing any such higher values.

At the same time, until new gas valuation rules are put into place, STRAC recognizes that there is a need in terms of current audits to clarify the matters raised by MMS' current proposed rule on FERC 636. MMS has proposed to make this rule effective retroactively to May 18, 1992, the date of FERC Order 636. Thus, any further delay in finalizing the rule will impact the current MMS audit program.

Third, each of the specific costs addressed in the MMS proposal must be evaluated in terms of the principles that (1) the lessee has a duty to market production in a manner beneficial to the lessor, and (2) that marketing costs are not a deductible expense. Under these principles, whether some of the costs discussed in the MMS proposal should be deemed nondeductible marketing expenses or deductible transportation expenses is a highly debatable proposition. Thus, for example, firm demand charges secure the right to transport preferentially, secure access to premium markets, and are necessary for prudent marketing. MMS does not allow deduction of marketing or brokerage fees, which enhance gas values, and on similar grounds, firm demand charges can rightfully be viewed as marketing related and nondeductible. In STRAC's view, on each debatable cost, MMS' proposal clearly benefits the lessees.

STRAC specifically opposes the following provisions of the MMS proposal.

(1) Gas Supply Realignment Costs. §§206.157 (f)(2) and 206.177(f)(2). STRAC opposes MMS' proposal to permit the deduction of Gas Supply Realignment Costs ("GSR"). These costs are transitory and have nothing to do with a pipeline's transportation related costs. Rather, these costs relate only to monies paid out by pipelines to reform or terminate gas purchase contracts. Moreover,

there is an inherent inequity in industry's position that they should not be required to pay royalties on contract reformation payments they receive, but should be entitled to deduct those payments when embedded in a tariff. Indeed, there is an inconsistency between MMS' position that contract reformation payments are both royalty bearing and deductible.

Because inclusion of these GSR costs in tariffs is not transportation related, STRAC opposes the MMS proposal. However, as a compromise position, STRAC would not oppose a modification to the MMS proposal that would permit lessees that did not receive any contract reformation payments to deduct GSR costs.

(2) GRI and ACA Fees. §§206.157(5) and (6); 206.177(f)(5) and (6). STRAC recognizes that these fees are a *de minimis* portion of any tariff. However, under no stretch of the imagination can they be viewed as transportation related. STRAC fails to credit MMS' rationale for allowing the deduction of these fees, which is simply that they are currently allowed. This could be a justification for many of the costs outlined in the MMS proposal.

(3) Supplemental Services Necessary for Transportation. §§206.157(f)(8); 206.177(f)(8). MMS proposes to permit deduction of certain costs of compression, dehydration and treatment of gas "where the pipeline performs additional compression, dehydration, or other treatment of gas to remove impurities during the transportation process." Such costs have traditionally been viewed as part of the lessee's duty to place production in a marketable condition. Where those costs are incurred during the transportation process should not be determinative of the lessee's duty. Moreover, this provision invites dispute and litigation over what is "typical" or "unusual" in any given situation.

(4) Firm Demand Charges. §§206.157(f)(1); 206.177(f)(2). As noted above, STRAC believes that it is debatable whether firm demand charges should be classified as marketing or transportation expenses. However, with some caveats, STRAC does not oppose the MMS proposal *in toto*, believing that MMS' effort to narrow the deductibility of these charges represents a reasonable compromise of a difficult issue. STRAC's first caveat is that MMS should be entitled to review the costs included in the firm demand charge, which should be adjusted if those costs: (a) include otherwise nondeductible costs, e.g. marketing and management trips, advance spending in non-transportation areas, or (b) otherwise do not reflect the lessee's reasonable actual costs of transportation. Second, STRAC recommends that these provisions be modified to recognize that the allowance would be reduced where a purchaser reimburses, directly or indirectly (e.g., through "reservation charges or fees"), all or a portion of the producer's demand charges.

(5) Actual or Theoretical Losses. §§206.157(f)(7); 206.177(f)(7). MMS recognizes that such costs are not deductible in non-arm's-length arrangements, but would permit the deduction in non-arm's-length situations where the allowance is based on a tariff. As discussed above, STRAC does not view the existence of a tariff as a justification for permitting the deduction of an otherwise nondeductible cost.

STRAC supports the remainder of the MMS proposal and particularly §§206.157(g) and 206.177(g), which details the nonallowable costs.

Although STRAC opposes several provisions of the MMS proposed rule and has concerns about MMS' overreliance on tariffs for purposes of determining transportation allowances, STRAC does recognize the FERC 636 environment raises particularly difficult issues for royalty valuation and commends MMS for its attempt to reach a compromise proposal.

Sincerely,

Wanda Fleming

Wanda Fleming
Chair